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# Common interest realty associations industry developments - 2003/04; Audit risk alerts

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## Recommended Citation

American Institute of Certified Public Accountants, "Common interest realty associations industry developments - 2003/04; Audit risk alerts" (2003). *Industry Developments and Alerts*. 687.  
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AUDIT RISK ALERTS

# Common Interest Realty Associations Industry Developments — 2003/04

*Strengthening Audit Integrity  
Safeguarding Financial Reporting*

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

**AICPA**

AUDIT RISK ALERTS

# **Common Interest Realty Associations Industry Developments — 2003/04**

*Strengthening Audit Integrity  
Safeguarding Financial Reporting*

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

**AICPA**

# Notice To Readers

This Audit Risk Alert is intended to provide auditors of financial statements of common interest realty associations with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform.

This publication is an *Other Auditing Publication* as defined in Statement on Auditing Standards (SAS) No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150). Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply SASs.

If an auditor applies the auditing guidance included in an Other Auditing Publication, he or she should be satisfied that, in his or her judgment, it is both appropriate and relevant to the circumstances of his or her audit. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

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## **Acknowledgements**

The AICPA staff is grateful to the following firms and individuals for their contributions to this Alert:

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Jeffrey L. Ducker, CPA

Candido Fernandez, CPA

Jules C. Frankel, CPA, MBA

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## ***Common Interest Realty Associations Industry Developments—2003/04***

### **How This Alert Helps You**

This Audit Risk Alert helps you plan and perform your common interest realty association (CIRA) audits. The knowledge delivered by this Alert assists you in achieving a more robust understanding of the business and economic environment in which your clients operate—an understanding that is more clearly linked to the assessment of the risk of material misstatement of the financial statements. Also, this Alert delivers information about emerging practice issues and current accounting, auditing, and regulatory developments.

If you understand what is happening in the CIRA industry and you can interpret and add value to that information, you will be able to offer valuable service and advice to your clients. This Alert assists you in making considerable strides in gaining that industry knowledge and understanding it.

### **Current Economic and Industry Developments**

For a complete overview of the current economic environment in the United States, see the AICPA general *Audit Risk Alert—2003/04* (product no. 022334kk).

### **CIRA Housing Growth and Economics**

The housing market has played a major role in sustaining U.S. economic growth. Despite recent projections indicating declines in single-family and multifamily housing starts, the figures still remain at all time highs. By the end of 2003, single-family starts should total nearly 1.48 million units and multifamily starts should total nearly 344,000 units. Estimates suggest that at least 80 percent of the single-family starts are in some type of CIRA,



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which would equate to around 8,000 to 12,000 new community associations created in 2003. By the end of the year, estimates indicate that approximately 20 million housing units will exist in some form of CIRA.

Based on those figures, the aggregate resale value for all homes in CIRAs would be in excess of \$2.25 trillion dollars and annual CIRA assessments are estimated to be \$35 to \$40 billion. Annual reserve contributions and expenditures by CIRAs are estimated to be \$20 to \$25 billion, and home improvement expenditures by CIRA homeowners are nearly \$20 billion

Condominium unit pricing increased by over 15 percent from last year with a median price of \$163,500, just 3 percent less than the median price of a single-family home of \$168,500.

### **XML (Extensible Markup Language) & XBRL (Extensible Business Reporting Language)**

The Community Associations Institute (CAI) has formed an XML/XBRL task force to develop schemas for online transmission of community association information. CAI has completed a draft XML Schema for Community Association Homeowner Data that will be released in the fall of 2003 for public comment. The CAI Task Force is completing draft schemas for the legal definition of community associations, payment processing in associations, and the definition of revenue in associations. The task force's goal is to produce XML schemas to allow for easily transportable financial information. The CAI and the CAI Research Foundation are hosting a meeting with the Census Bureau, the American Housing Survey, the National Association of Realtors, the National Association of Homebuilders, and others during the fall of 2003 to clarify the data collection needs for CIRAs.

### **Federal Trade Commission's New Telemarketing Sales Rule**

The Federal Trade Commission (FTC) has been developing a new telemarketing sales rule. The new rule includes the following provisions:

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- A national do-not-call registry
  - A toll-free consumer complaint line
  - Lists to be scrubbed every three months
  - Investigation to be generated after three complaints, possibly resulting in fines up to \$11,000 per violation
  - A requirement that telemarketers transmit caller ID information within one year

The true impact of the FTC's new telemarketing rule will not be known until the process of understanding, interpreting, and applying it to vacation ownership marketing practices is completed. Actual implementation of the rule's regulatory requirements will not begin until next summer or later. For additional information and to stay current on more recent developments, readers may refer to [www.FTC.gov](http://www.FTC.gov) and [www.arda.org](http://www.arda.org).

## **Regulatory Developments**

The operations of CIRAs are regulated by the individual states and not by the federal government. However, federal regulations, court cases, IRS revenue rulings, and federal legislation apply to the income tax treatment of CIRAs. Also, two federal agencies, the Federal Housing Administration (FHA) and the Department of Veterans Affairs, as well as two government-sponsored enterprises (GSEs), the Federal Home Loan Mortgage Corporation (FreddieMac) and the Federal National Mortgage Association (FannieMae), have regulations and underwriting guidelines to guide developers, mortgage lenders, and others in establishing CIRAs as well as in selling and financing units. Although compliance with such regulations may not be mandatory, compliance with their guidelines and underwriting requirements facilitates the development, sale, and resale of units within CIRAs. This section discusses recent developments in federal regulations as they relate to CIRAs, including U.S. Department of Housing and Urban Development (HUD) requirements, IRS private letter rulings, and bankruptcy legislation.

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**Help Desk**—To obtain copies of the HUD handbooks, notices, and other documents, go to [www.hudclips.org](http://www.hudclips.org), where they are available for printing or viewing. Printed handbooks can be ordered online through the Direct Distribution System or by telephone at (800) 767-7468.

## **Current Developments in the Guidelines for Calculating and Retaining Section 236 Excess Income**

As discussed in a prior Alert, on July 27, 2001, the HUD Office of Housing issued Notice H 01-7, *Guidelines for Calculating and Retaining Section 236 Excess Income*, which supersedes Notice H 00-17. Notice H 01-7, which expired July 31, 2002, applied to all section 236 projects (the typical HUD CIRA would be a housing cooperative) receiving assistance through the section 236 interest reduction payment program. HUD Notice H 01-7 provided guidelines for implementation of section 216 of the department's fiscal year 2001 Appropriations Act, P.L. 106377. Section 861 of the American Homeownership and Economic Opportunity Act of 2000 amends section 236(g) of the National Housing Act, providing an extension of the authority to retain excess income. It also provides that any excess income that a project owner has collected and has not remitted to the secretary of HUD may be retained by such owner unless the secretary otherwise provides. Instructions are provided for an owner's participating in retention of excess income for projects receiving assistance through the section 236 interest reduction payments program.

Excess income comprises cash collected as rent from residents by the mortgagor, on a unit-by-unit basis, that is higher than the HUD-approved unassisted basic rent. Excess income may be used for any project purpose, such as project operating shortfalls and repair costs that are applicable to CIRA clients. Another project use applicable to CIRA clients is increasing deposits to the reserve fund for replacements to a limit necessary to fund the reserve adequately.

Readers should be aware that the HUD Office of Housing issued Notice H 02-14, *Guidelines for Calculating and Retaining Section 236 Excess Income*, on July 17, 2002. Notice H 02-14, which

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expired July 31, 2003, was an extension of Notice H 01-07, as clarified by Notice H 02-09, *Technical Corrections*, issued on May 10, 2002. The HUD Office of Housing then issued Notice H 03-13 on July 15, 2003; this is yet another extension of Notice H 02-14, as clarified by Notice H 02-09, *Technical Corrections*, issued May 10, 2002. Notice H 02-14 is now being extended to July 31, 2004.

**Help Desk**—For additional guidance, refer to HUD Notices H 01-7, H 02-14, and H 03-13 at [www.hudclips.org](http://www.hudclips.org), which contains sections on policy, retaining section 236 excess income, usage of excess income, requesting approval, treatment of excess income previously collected, and reporting requirements.

## **HUD Issues Final Rule on Property Flipping**

HUD has issued new requirements regarding the eligibility of properties to be financed with Federal Housing Administration mortgage insurance, making flipped properties ineligible for FHA-insured mortgage financing.

## **IRS Revenue Rulings**

A revenue ruling is an official interpretation by the IRS of the Internal Revenue Code (IRC), related statutes, tax treaties, and regulations. It is the conclusion of the IRS on how the law is applied to a specific set of facts. Revenue rulings are published in the Internal Revenue Bulletin for the information of and guidance to taxpayers, IRS personnel, and tax professionals. They can be used as guidance if your client encounters a similar situation. The following ruling may affect CIRAs.

### *Revenue Ruling 2001-60*

Revenue Ruling 2001-60, addresses the following issue: Are land preparation costs incurred by a taxpayer in the original construction or reconstruction of golf course greens subject to an allowance for depreciation under 167 of the Internal Revenue Code?

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Revenue Ruling 2001-60 provides guidance on the proper tax treatment of land preparation costs in the construction or reconstruction of golf course greens. The ruling replaces Revenue Ruling 55-290, 1955-1 C.B. 320. While Revenue Ruling 2001-60 continues to apply the holding of Revenue Ruling 55-290 regarding the treatment of land preparation costs attributable to the construction or reconstruction of push-up or natural soil greens, the ruling reaches a different conclusion regarding the treatment of the costs of land preparation undertaken in the construction or reconstruction of modern golf course greens. On February 7, 2002, the Industry Director, Communications, Technology and Media, and the Deputy Director — Compliance (SBSE) issued a memorandum that provides direction to examiners on applying the concepts of Revenue Ruling 2001-60 to other golf course land components. These components include tee boxes, sand bunkers, fairways, and roughs.

With the release of Revenue Ruling 2001-60, 2001-51 I.R.B. 587, taxpayers should expect to file Forms 3115, Application for Change in Accounting Method, to conform their treatment of the costs of modern golf course greens to that of the ruling. The ruling allows for depreciation under IRC Sections 167 and 168 of certain land preparation costs in the original construction or reconstruction of modern golf course greens. The ruling represents a substantial change in the treatment of such costs. In the past, the IRS relied on Revenue Ruling 55-290., 1955-1 C.B. 320. This ruling provided that expenditures incurred by a taxpayer in the original construction of golf course greens are capital expenditures that should be added to the original cost of the land and are not subject to an allowance for depreciation. Although Revenue Ruling 2001-60 reaches a different conclusion from Revenue Ruling 55-290 with respect to the construction of the modern golf course green, Revenue Ruling 2001-60 will continue to apply the holding of Revenue Ruling 55-290 to the construction of the push-up or natural soil greens.

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**Help Desk**—For more information on golf course land improvement costs, go to [www.irs.gov/businesses/article/0,,id=107937,00.html](http://www.irs.gov/businesses/article/0,,id=107937,00.html) for the complete revenue ruling and memorandums issued to examiners. This guidance marks one of the first issues of the new Industry Issue Resolution (IIR) Program aimed at establishing consistent IRS positions on complicated or controversial tax issues.

## **Pooled Method of Reserve Funding**

Reserve assessments are probably one of the biggest issues in association taxation because they are so misunderstood. Many practitioners treat the entire reserve assessment as simply a capital contribution for tax purposes, without any regard to its technical compliance as a capital contribution. In certain instances, the reserve preparer can provide component information so that capital and noncapital component allocations can be determined by the CPA. Contributions for capital replacements are exempt from taxation regardless of the federal income tax method (1120 or 1120H) utilized.

Tax law on monies contributed to a corporation as capital contributions is very specific about the requirements for assessments to qualify as a capital contribution (meaning “capital” in nature, as opposed to annual or non annual operating in nature) in a nonexempt membership organization. The requirements are:

1. Funds must be earmarked for a specific capital purpose. (See court case citation *Maryland Country Club, Chicago Board of Trade, Gibbons*, GCM 35929, and Revenue Rulings 74-563, 75-370, 75-371 for guidance.)
2. Members must be notified in advance of the purpose of the assessment. (See court case citation *Maryland Country Club, Chicago Board of Trade*, and Revenue Rulings 74-563, 75-370, 75-371 for guidance.)
3. Funds must be accounted for as a capital assessment. (See court case citation *Maryland Country Club* and *Chicago Board of Trade* for guidance.)

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4. Funds must be placed into a separate bank account. (See court case citation Maryland Country Club, GCM 35929, and Revenue Rulings 74-563, 75-370, 75-371 for guidance.)
  5. Funds must actually be expended for the specific capital purpose. (See court case citation Maryland Country Club, GCM 35929 for guidance.)
  6. The money must add value to the contributor's capital account, (as defined in IRC Section 1016). (See court case citation Chicago Board of Trade, GCM 35929 for guidance.) (The purpose of this requirement is that the contributor (member) receive some immediate value for the capital contributed, rather than simply making a payment for the expectation of future services (which would not qualify as being "capital" in nature).)

Currently, most of the major national reserve preparers use the pooled method. Recently, in Florida, there has been an increase in the frequency of adoption of the cash flow or pooled method of reserve funding by condominium associations. Until a short time ago in Florida, in order for an association to adopt the pooled method, the majority of the association's unit owners were first required to waive statutory (straight-line) funding. The administrative rules to the Florida statutes were recently amended to permit the funding of reserves based on either a separate analysis of each of the required assets (straight-line) or a pooled analysis of two or more of the required assets.

The application of the pooled method of reserve funding is set forth in Section 61B-22.005 of the Florida Administrative Code (FAC), which interprets, enforces, and implements the Florida statutes. Section 718.112(2)(f) FS of the FAC stipulates that the annual contribution to the reserves is calculated to provide a positive cash flow, considering projected estimated expenditures to repair and replace the common property, over a specified period. Generally, the pooled method of reserve funding results in a substantially lower assessment to unit owners. Also, reserve

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funds may be used for any of the items in the pool, without a unit owner vote. It should be noted that this approach is used in Hawaii, as well, and may be used elsewhere.

For associations that have adopted pooled reserve funding, a question arises regarding the treatment of reserve assessments in preparation of Form 1120. Upon adoption, the association will fund its reserves in an aggregate amount instead of by specific component. The IRS citations identified above set forth that the amount or proportion to be used for capital improvements must be stated at the time of the assessment, earmarked for that purpose at time of receipt, and expended for the specific capital purpose. Accordingly, associations filing Form 1120 and using the pooled method of reserve funding must be able to establish a reasonable proration of the assessment pertaining to capital improvements; otherwise, the entire assessment would be taxable. In establishing such a proration, consideration should be given to using historical percentages or applying future cost relationships, as set forth in the reserve study. This breakdown may be obtained from some of the major reserve study firms.

## **Income Taxes**

The IRS settled a number of related tax audits in the San Diego area several years ago by allowing the associations to switch to Form 1120-H and pay the additional tax, penalties, and interest. Significantly, all the audits were of associations that filed Form 1120 under IRC Section 277. It was felt at the time that the IRS simply bowed to the intense pressure and publicity given this issue by the industry. The IRS position was very strong, and the only case to go to court resulted in a summary judgment decision in favor of the IRS.

Practitioners should continue to be aware of the risks associated with filing Form 1120 and advise their clients to do so only when they have fully complied with IRS guidelines.



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## Bankruptcy Legislation Still in Washington

Bankruptcies have been setting all-time records of late. According to bankruptcy profiles, two out of three individuals who file petitions have lost their job. Thus, we can see that as unemployment rises, so does the bankruptcy rate.

Although bankruptcy reform has stalled numerous times, its prospects seem to be improving. In March 2003, the Bankruptcy Abuse Prevention and Consumer Protection Act (HR975) was finally passed in the House and Senate. Now, certain issues in the legislation need to be resolved between both houses of Congress. It will then go to the president, who has indicated that he will sign the bill into law. Once signed, the provisions of the law will be effective in 180 days. Readers should be alert to the passage of the bill into law.

For years, banks and creditors have argued that the Bankruptcy Code needs to be more rigid to curtail abuse by borrowers who are eluding debts that they can afford to repay. The aforementioned legislation would make it more difficult for debtors to file under Chapter 7 of the Bankruptcy Code, which allows them to shun debts after liquidating assets. More debtors would have to file Chapter 13, which requires repayment of most or all debts, while still giving them the right to have the rest of their debt expunged.

The passing of this law is important to CIRAs because it will make it easier for them to collect postpetition assessments<sup>1</sup> and carrying charges<sup>2</sup> from an owner-shareholder who does not relinquish his or her ownership interest in the unit. Under the

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1. Postpetition assessments are the bankrupt owner's proportionate share of the amount of money necessary to pay for the operation, administration, maintenance, and management of the common property and funds for future major repairs and replacements, late charges, and interest incurred after the date the bankruptcy was filed.
  2. Carrying charges (commonly referred to as rent) are charged to tenant-shareholders for operating and capital expenditures based on proprietary lease agreements in cooperative housing corporations.

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current law, collection of such assessments and charges is tied to occupancy or subletting. Some owner-shareholders engage in “under the table” subletting or allow friends or relatives to stay in the unit rent-free, thereby escaping liability for postpetition monthly assessments and charges.

## **Engagement Issues**

### **The Requirement for a Management Representation Letter**

A review of financial statements consists principally of inquiries of company personnel and analytical procedures applied to financial data. As part of a review of financial statements, the accountant is required to obtain a written representation from his or her client to confirm the oral representations made to the accountant. The accountant should obtain a representation letter from the board of directors and those members of management whom the accountant believes are responsible for and knowledgeable, directly or through others in the organization, about the matters covered in the representation letter. A management representation letter is not required in a compilation engagement.

Normally, the appropriate officers of the CIRA and the managing agent, if any, would sign the management representation letter. Readers should be aware that, in response to the issuance of Statement on Standards for Accounting and Review Services (SSARS) No. 9, *Omnibus Statement on Standards for Accounting and Review Services—2002* (AICPA, *Professional Standards*, vol. 2, AR sec. 100), the Accounting and Review Services Committee issued an updated illustrative representation letter. The revised representation letter addresses specific requirements and replaces the existing letter in Appendix F of SSARS No. 1, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2, AR sec. 100). Readers may refer to Appendix A of this Alert for an example of a management representation letter prepared in connection with a review. Also, Appendix B of the AICPA Audit and Accounting Guide *Common Interest Realty*

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*Associations* presents sample CIRA-specific representation letters. In addition, Appendix B of Statement on Auditing Standards (SAS) No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333), as amended, contains a list of other representations that may be appropriate in certain situations.

## **Inquiries and Analytical Procedures in a SSARS Review Engagement**

In current practice, there is uncertainty among some practitioners as to what procedures to perform during a review engagement, without reaching the level of performing audit procedures. Below is some guidance to help accountants and their staff perform a review efficiently.

*What are the required inquiries in a SSARS review engagement?* SSARS No. 1 requires that the accountant should ordinarily include inquiries directed to the following:

- The CIRA's accounting principles and practices and the methods followed in applying them
- The CIRA's procedures for recording, classifying, and summarizing transactions, and for accumulating information for disclosure in the financial statements
- Actions taken at meetings of stockholders, board of directors, committees of the board of directors, or comparable meetings that may affect the financial statements
- Persons having responsibility for financial and accounting matters concerning (1) whether the financial statements have been prepared in conformity with generally accepted accounting principles (GAAP) consistently applied, (2) changes in the CIRA's business activities or accounting principles and practices, (3) matters as to which questions have arisen in the course of applying the foregoing procedures, and (4) events subsequent to the date of the financial statements that would have a material effect on the financial statements

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*Can I modify them?* Appendix A of SSARS No. 1 contains illustrative inquiries for a review engagement. Nevertheless, because the inquiries to be made in a review engagement are a matter of your judgment, these illustrative inquiries are not to serve as a program or a checklist in the conduct of a review. Rather, they are guidelines and a frame of reference. Tailor specific inquiries to the CIRA based on your understanding of the client's business and the CIRA industry.

*What are the requirements of analytical procedures?* SSARS No. 1 states that the accountant's analytical procedures should ordinarily consist of procedures designed to identify relationships and individual items that appear to be unusual. For a review engagement, these procedures fall into three categories:

1. Comparison of the financial statements with statements for comparable prior period(s). An example would be trend analysis, which involves the study of the change in accounts over time.
2. Comparison of the financial statements with anticipated results, if available (for example, budgets and forecasts). An example would be comparing budgeted amounts with actual amounts and identifying significant variances.
3. Study of the relationships among the elements of the financial statements that would be expected to conform to a predictable pattern based on the entity's experience. An example would be reasonableness tests that estimate a financial statement amount or the change in amount from the prior period.

A basic premise underlying the application of analytical procedures is that relationships among data may reasonably be expected to exist and continue to exist in the absence of known conditions to the contrary.

Specific analytical procedures used are a matter of your judgment. Therefore, you should tailor the specific procedures to the CIRA client based on your understanding of the client's business and the CIRA industry.

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In applying analytical procedures in a CIRA review engagement, you may achieve both effectiveness and efficiency by using the following approach:

1. Identify immaterial account balances or classes of transactions related to asset accounts. Apply no analytical procedures to them.
2. Identify account balances or classes of transactions to which you have applied other accounting services (book-keeping or payroll services, for example). Consider the evidence that you already have and whether any material errors are likely to remain. If you believe you already have sufficient evidence for those account balances or classes of transactions to reduce the risk of material misstatement to a moderate level, do not apply analytical procedures to them.
3. For the remaining account balances and classes of transactions, develop expectations (for example, using historical trends adjusted for known changes) for them.
4. Consider how close the existing account balance or class of transaction comes to the expectation developed in number 3, above. If the differences are small, no additional evidence is needed.
5. If the differences are large, material errors could exist. Inquire about valid business reasons for the difference. If the results of inquiry are plausible and agree with other evidence, no additional evidence may be needed.
6. If additional evidence is needed, apply additional procedures or obtain other suitable evidence.

*What is the purpose of inquiries and analytical procedures?* Overall, the purpose of the inquiries and analytical procedures is to provide you with the primary basis for expressing limited assurance that no material modifications should be made to the financial statements. SSARS No. 1 does not specify how many procedures must be performed in order to express the limited

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assurance. The extent and type of procedures performed are a matter of professional judgment.

Keep in mind, too, that SSARSs allow modification of inquiry and analytical procedures. For example, you may have acquired knowledge about the CIRA in the performance of audits of the CIRA's financial statements, compilation of the CIRA's financial statements, or other accounting services (such as bookkeeping services). This acquired knowledge may be sufficient to reduce the extent of inquiries and analytical procedures, although you would still have the same degree of responsibility with respect to the financial statements (i.e., expressing limited assurance that no material modifications should be made to the financial statements).

### **Responsibility for Fraud**

You are not required to document your assessment of fraud in a compilation or review engagement. Further, you are not required to plan or perform a compilation or review engagement to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Nor are you required to gain an understanding of the client's internal control when conducting a compilation or review engagement. This does not, however, relieve you of responsibility if incorrect, incomplete, or otherwise unsatisfactory information comes to your attention during the engagement and you fail to act upon it accordingly.

Also, in light of the current fraud awareness environment, treasurers of CIRAs should consider being more involved in reviewing internal controls and performing internal control procedures, such as reviewing bank reconciliations on a monthly basis for accuracy and completeness.

SSARS No. 1 (AR sec. 100.09) requires you to obtain additional or revised information if you become aware, while conducting a compilation engagement, that information supplied by the client is incorrect, incomplete, or otherwise unsatisfactory. If the client

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refuses to provide additional or revised information, you should withdraw from the engagement.

In a review engagement, if you become aware that information supplied by the client is incorrect, incomplete, or otherwise unsatisfactory, you should perform the additional procedures you deem necessary to achieve limited assurance that there are no material modifications that should be made to the financial statements for them to be in conformity with GAAP.<sup>3</sup> When the accountant is unable to perform the inquiry and analytical procedures he or she considers necessary to achieve the limited assurance contemplated by the review, or the client does not provide the accountant with a representation letter, the review will be incomplete. A review that is incomplete is not an adequate basis for issuing a review report. In such a situation, the accountant should consider the matters discussed in paragraphs 100.46 through 100.51 of AICPA, *Professional Standards*, vol. 2, in deciding whether it is appropriate to issue a compilation report on the financial statements.

Although management (whether the board of directors alone or the board with the assistance of a management company) is responsible for the prevention and detection of fraud and the maintenance of internal control, many small business clients, including CIRA boards of directors, do not understand management's responsibility. These clients may have unrealistic expectations and may assume that you are providing a higher level of assurance than you were engaged to do, including detecting fraud and internal control weaknesses. We present here some ways for you to clarify for your client each party's responsibility.

Paragraph 5 of SSARS No. 1 (AR sec. 100.05) states:

The accountant should establish an understanding with the entity, preferably in writing, regarding the services to be performed...the understanding should include a description of the nature and limitations of the services to be performed and a description of the report, if a report is to be issued. The un-

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3. Or financial statements prepared on another comprehensive basis of accounting.

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derstanding should also provide (a) that the engagement cannot be relied upon to disclose errors, fraud, or illegal acts and (b) that the accountant will inform the appropriate level of management of any material errors that come to his or her attention and fraud or illegal acts that come to his or her attention, unless they are clearly inconsequential.

A written engagement letter, though not required in a compilation or review engagement (except in the case of a management-use-only compilation), may be helpful in clarifying and documenting your understanding with the client about your responsibility regarding fraud and internal control weaknesses. The language suggested for use in the review engagement letter is illustrated in Appendix E of SSARS No. 1 (AR sec. 100.61), an excerpt from which follows:

A review does not contemplate obtaining an understanding of internal control or assessing control risk, tests of accounting records and responses to inquiries by obtaining corroborating evidential matter, and certain other procedures ordinarily performed during an audit. Thus, a review does not provide assurance that we will become aware of all significant matters that would be disclosed in an audit. Our engagement cannot be relied upon to disclose errors, fraud, or illegal acts that may exist. However, we will inform the appropriate level of management of any material errors that come to our attention and any fraud or illegal acts that come to our attention, unless they are clearly inconsequential.

Similarly, the language illustrated in Appendix C and Appendix D of SSARS No. 1 (AR secs. 100.59 and 100.60) for an engagement letter for a compilation engagement includes the following:

Our engagement cannot be relied upon to disclose errors, fraud, or illegal acts that may exist. However, we will inform the appropriate level of management of any material errors that come to our attention and any fraud or illegal acts that come to our attention, unless clearly inconsequential.

Language can also be added to a compilation engagement letter to indicate that a compilation does not require you to obtain an



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understanding of the entity's internal control or identify internal control weaknesses.

In addition to providing a clearly expressed engagement letter, a second way to minimize misunderstandings is to make clear to your client his or her responsibility to prevent and detect fraud. An effective way to do this is to educate your client as to the importance of internal control in the prevention of fraud.<sup>4</sup> You are then in a position to work with the client in a separate consulting engagement to improve the client's internal control. This exercise results in several benefits for both you and the client. One benefit is the client's increased awareness of the importance of internal control in the prevention and detection of fraud. In addition, this exercise clarifies management's responsibility to prevent and detect fraud, thereby reducing your legal risk. Finally, in the process of offering this type of consulting service to the client, you have the opportunity to gain knowledge of the client's business, thereby becoming more valuable to the client.

## **Audit Issues and Developments**

### **Collectibility of Assessments Receivables (Allowance for Doubtful Accounts)**

As mentioned earlier in this Alert, personal bankruptcies have reached record levels. Therefore, special attention may need to be paid to the adequacy of the allowance for bad debts at CIRAs.

The CIRA's estimate of the level of assessments receivable that may not be collectible as a result of bad debts is reflected in the allowance for doubtful accounts, which is one of the offsets used to bring assessments receivable to their net realizable value. An audit of the allowance for doubtful accounts is an audit of an accounting estimate. When auditing estimates, auditors should be familiar with Statement on Auditing Standards (SAS) No. 57,

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4. Readers may refer to SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, Professional Standards, vol. 1, AU sec. 316), which contains an exhibit entitled, Management Antifraud Programs and Controls, for further guidance to help prevent, deter, and detect fraud. This exhibit can also be used to help educate the client.

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*Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), which provides guidance on obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates used in a CIRA's financial statements. The guidelines set forth by SAS No. 57 include the following:

- Identifying the circumstances that require accounting estimates
- Considering internal control relating to developing accounting estimates
- Evaluating the reasonableness of management's estimate

As part of evaluating reasonableness, the auditor should obtain an understanding of how management developed the estimate for the allowance for doubtful accounts and, based on that understanding, use one or a combination of the following approaches listed in SAS No. 57:

- Review and test the process used by management to develop the estimate.
- Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate.
- Review subsequent events or transactions occurring prior to completion of fieldwork.

A review of the aging of the assessments receivable is often performed. This may include testing the reliability of the aging report, reviewing past-due accounts on the report, including the number and amount of such accounts, and reviewing past-due balances, the CIRA's prior history in collecting past-due balances, owner correspondence files and credit reports, and so forth. This may be done with the assistance of the CIRA in obtaining an understanding of how the allowance was developed and determining whether it is reasonable.

Another very useful tool in evaluating the allowance for doubtful accounts is the application of analytical procedures. According to

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SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329.02), analytical procedures are an important part of the audit process and consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data. Often, the large number of owner accounts makes it difficult to determine the adequacy of the allowance by reference only to individual accounts, making analytical procedures helpful to the audit process. The following are examples of the ratios that auditors might use to evaluate collectibility of assessments receivable:

### Assessment Collection Ratios

- *Assessments receivable turnover* indicates how well the CIRA collects its receivables and is computed as net assessments revenue divided by average net assessments receivable.
- *Bad debts to net assessments revenue* indicates whether writeoffs are adequate. It is computed as bad debt expense divided by net assessments revenue.
- *Doubtful accounts allowance to assessments receivable* indicates whether the allowance account is adequate. It is computed as allowance for doubtful accounts divided by assessments receivable.

The auditor may also review revenue and receivables transactions and fluctuations after the balance-sheet date for items such as writeoffs. This may provide additional information about the collectibility of the assessments receivable and the reasonableness of the allowance account at the balance-sheet date.

The auditor will, of course, use his or her professional judgment to determine which of these and other procedures to perform to obtain the evidence needed to judge whether the allowance is reasonable. The auditor may also obtain information from a collection agency regarding its evaluation of the situation, since a collection agency is likely to have acquired specific financial information about the owner and the unit. The CIRA attorney may be consulted as well through the use of a legal confirmation for the allowance.

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## **Increased Outsourcing to Third-Party Service Organizations**

More and more associations are contracting with outside service organizations or property management companies to help manage the CIRA's financial administration by providing book-keeping and accounting services. These services could have a material effect on the internal control and the financial information systems of an association.

### **Internal Control Considerations**

Associations need to implement effective internal control over transactions performed by third parties. When an association uses a third party or service organization, transactions that affect the association's financial statements are subjected to controls that are, at least in part, physically and operationally separate from the association. The significance of the controls of the service organization to those of the association depends on the nature of the services provided by the service organization, primarily the nature and materiality of the transactions it processes for the association and the degree of interaction between its activities and those of the association. As always, extra controls should be in place when coinage or cash is involved.

### **Auditing Considerations**

An auditor should obtain an understanding of each of the five components of an association's internal control sufficient to plan the audit. This understanding may encompass controls placed in operation by the association and by service organizations whose services are part of the association's information system. In planning the audit, such knowledge should be used to:

- Identify types of potential misstatements.
- Consider factors that affect the risk of material misstatement.
- Design tests of controls, when applicable.
- Design substantive tests.

SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), provides guidance on the factors

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an auditor should consider when auditing the financial statements of an entity that uses a service organization to process certain transactions. SAS No. 70 guides an auditor through planning, understanding controls, assessing control risk, contacting the service organization, using a service auditor, and other essential matters.

**Help Desk**—The Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* is designed to provide guidance to service auditors engaged to issue reports on a service organization's controls that may be part of a user organization's information system in the context of an audit of financial statements. The Guide also provides guidance to user auditors engaged to audit the financial statements of entities that use service organizations. Guidance on performing service auditors' engagements and using service auditors' reports in audits of financial statements is provided in SAS No. 70, *Service Organizations, as Amended*. This Guide also provides guidance on the use of subservice organizations.

## **Documenting Other Revenue**

Information about other nonassessment or noncarrying charge revenues and amounts for such items as valet, laundry, and vending machine income should be presented in the statement of revenues and expenses. Many associations charge nonmembers for the use of the association's parking facilities and swimming pools and charge members for laundry services and vending machines. If any of these other revenues is material, the revenue should be supported, conceivably by performing analytical procedures such as budget-to-actual comparisons. In circumstances where the revenue-generating service has recently been implemented and there is no historical data available to provide the basis for a budget, analytical procedures would be inappropriate. In that situation, the accountant may consider documenting the association's procedures for charging and collecting these funds and then develop a test of the system.

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## **Security Deposits**

Many associations have security deposit liabilities on their books for deposits received for tenants of owners. Quite a few associations have inadequate controls over the accounting for their security deposits received. Many have amounts recorded in their general ledger that are not supported by detail listings, or the detail listings they have include owners who may have moved out years ago. The association may “clean up the books” by recording these items as income, but the answer is not always that simple. California has very specific escheat laws on this issue, as does Nevada. Virtually all states have similar laws. Some CIRA’s may adopt agreements with owners that unclaimed deposits will be available for the CIRA to retain as income.

Practitioners and their clients may be subject to these state laws. Accordingly, practitioners should be adequately informed about the laws applicable to these deposits to help assess the proper accounting for them and to provide advice to their clients.

## **Technology and Internal Control Issues**

CIRAs and their management companies are becoming more technologically savvy, using computer and communications technology to help run their business and maintain their financial records. In this section, we revisit our audit techniques and procedures as they relate to a paperless environment.

### **Audit Timing and Planning**

Some CIRAs may have information systems that automatically initiate, authorize, record, summarize, and settle transactions electronically without human intervention or physical documentation. As a result, key audit evidence is in electronic form and may exist for only a limited amount of time. Therefore, you will need to understand and be able to rely on IT general controls. Computer programs may summarize transactions on a periodic basis and then purge, update, change, modify, or write over the original detail records of the transaction. Traditionally, audit procedures are performed after a client’s fiscal year end. With

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Internet activities, however, traditional audit timing may be inadequate. One audit implication of sometimes short-term electronic evidence is that waiting until after the fiscal year end to begin auditing procedures may be too late to obtain competent sufficient evidence of controls or transactions.

SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311.09), states that “the extent to which computer processing is used in significant accounting applications, as well as the complexity of that processing, may also influence the nature, timing, and extent of audit procedures.”

Some CIRAs may not have hard-copy or paper evidence of transactions. Delivery, settlement, and authorization may be prepared and performed electronically, leaving no paper trail behind. The failure of CIRAs to retain the details of transactions can create troublesome issues for the auditor who is considering whether internal control is functioning as planned. According to SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326.18), as amended:

Certain electronic evidence may exist at a certain point in time. However, such evidence may not be retrievable after a specified period of time if files are changed and if backup files do not exist. Therefore, the auditor should consider the time during which information exists or is available in determining the nature, timing, and extent of his or her substantive tests, and if applicable, tests of controls.

If the retention of evidential matter is questionable, the auditor may want to begin audit procedures before year end. This may also drive the need for continuous auditing.

### **Adequate Technical Training**

The rapid evolution of technology has profound implications for all those affected by computer technology, including auditors. A CIRA's existing hardware and software may need to be replaced every 18 months, or more frequently. This rapid rate of technological change means that, to remain current, ongoing training in the underlying technologies is requisite.

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Auditing through the computer and the nature of electronic evidence require that the auditor gain a more detailed understanding of the controls over transactions and records than that traditionally obtained for paper-based manual audits. You can obtain more specific technology skills through technical training courses, seminars, IT reference materials, research, and other methods.

**Help Desk**—The AICPA provides the following courses that are helpful to CPAs working in the environment of e-business activities: Auditing in a Paperless Society (product no. 730121kk) and E-Commerce: Controls and Audit (product no. 731550kk). These courses are available from the AICPA Order Department at (888) 777-7077 and at CPA2Biz.com.

### **IT Specialists**

Because of rapid advances in technology, you may not have all the skills necessary to audit certain electronic and computer activities. You may need to engage IT audit specialists to perform certain procedures. Qualified IT specialists are sometimes available from another part of the firm, such as the consulting division or the internal IT support staff. If not, you may have to go outside your own organization to obtain qualified specialists.

Audit planning comes into play not only because of the lead time necessary to contract for a specialist's services, but also because of the time that may be required for the auditor to obtain the minimum technological knowledge necessary to supervise the specialist. Whether an IT specialist is on the auditor's staff or an outside professional, the IT specialist requires the same supervision and review as any assistant, as stated in SAS No. 22 (AU sec. 311.10):

If specialized skills are needed, the auditor should seek the assistance of a professional possessing such skills, who may be either on the auditor's staff or an outside professional. If the use of such a professional is planned, the auditor should have sufficient computer-related knowledge to communicate the objectives of the other professional's work; to evaluate whether the specified procedures will meet the auditor's objectives; and



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to evaluate the results of the procedures applied as they relate to the nature, timing, and extent of other planned audit procedures. The auditor's responsibilities with respect to using such a professional are equivalent to those for other assistants.

### **Internal Control Considerations**

SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as amended, provides guidance to auditors about the effect of IT on internal control and on the auditor's understanding of internal control and assessment of control risk. In some circumstances, auditors may need to perform tests of controls to perform an effective audit.

As noted earlier, technology continues to evolve rapidly. Most server software is constantly upgraded, modified, and configured with components from different vendors. Often, when software is upgraded, previous control settings are lost, with no warning to managers. If procedures are performed before year end, you have the additional responsibility to consider whether there are frequent and significant changes being made to the CIRA's systems that might affect the remainder of the period. According to SAS No. 55 (AU sec. 319.99):

When the auditor obtains evidential matter about the design or operation of controls during an interim period, he or she should determine what additional evidential matter should be obtained for the remaining period...The auditor should obtain evidential matter about the nature and extent of any significant changes in internal control, including its policies, procedures, and personnel, that occur subsequent to the interim period.

To test controls, auditors need access to networks, servers, and databases on which entities store their accounting records. IT managers may be reluctant to grant auditors the level of access they need, preferring instead to provide lengthy printouts, files on diskettes, or files as e-mail attachments. Access to copies of records in these forms is insufficient. Auditors should have full read-access rights to all system and database security settings and

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tables, as well as the underlying electronic accounting records, to gain a sufficient understanding of controls and to perform substantive tests.

### **The Importance of Monitoring**

A key control in a system of internal control is monitoring. Routers, firewalls, Web servers, e-mail servers, databases, and operating systems all have the ability to log traffic and specific security events. Properly implemented and controlled logs can provide some evidence that a transaction occurred and that the transaction record has not been altered.

### **Key Controls in an Electronic Environment**

To reduce the chance of an auditor's relying on evidence that lacks credibility, he or she should understand the key controls over validity, completeness, and integrity. In the electronic environment, these typically include the following:

- ***Segregation of duties.*** Different employees should perform the duties of security administration, security monitoring, system administration, application maintenance, software development, and daily accounting operations.
- ***Authorization.*** User access to networks, systems, servers, services, programs, data, and records should be authorized based on the organization's security policy and documented.
- ***Authentication.*** The identity of authorized users should be established by the use of log-on IDs, hard-to-guess and hard-to-crack passwords, and, where appropriate, smart cards.
- ***Access limitations.*** Authorized users should be granted access to networks and application systems only after they authenticate themselves, and their access rights should be commensurate with their job responsibilities.
- ***Activity logging.*** Logging should be enabled on all routers, firewalls, servers, databases, and operating systems. The

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logs should be protected from tampering and alteration and should be retained.

- ***Independent monitoring.*** Employees independent of the IT department should monitor the activity logs on a sufficiently frequent basis to detect suspicious, unusual, and unauthorized activity.
- ***Methods of error correction.*** Software should have controlled rollback procedures so records are not purged or lost when servers crash and programs abort. Controls preventing changes to historical records should be in place so errors are corrected by entries made by the accounting department. Programmers and other IT personnel should not be able to make changes to actual accounting records.
- ***Backup procedures.*** Grandfather, father, and son daily backup procedures should be performed, as well as weekly, monthly, quarterly, and annual backups. All files that include the details of transactions should be included in the backup. With the advice of legal counsel, the key user or owner of the data should establish retention schedules to satisfy legal and regulatory requirements. The backup media should have clear exterior identification, and there should be an offline log and inventory of what was backed up, when, by whom, and where stored. Backups should be stored in a safe location off site and tested periodically by the key user of the data.
- ***Disaster recovery.*** The nature of online services often requires that systems be capable of operating 24 hours a day, seven days a week. Even short periods of outage may mean significant financial loss to some CIRAs. There should be a written plan on how systems will roll over to alternative systems should the data center be destroyed or rendered inoperable. The plan should periodically be tested.

The strength of controls in an electronic environment is like a chain, where strength is determined by the weakest link. You should consider whether any weak links are present and, if so,

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consider the need to adjust your risk assessment and substantive tests accordingly.

## **Reserve Study Issues**

As more CIRA units age to the point that they are in need of significant repairs and replacements, shortcomings in many reserve studies are becoming apparent. Studies have either cost figures or measurement amounts that fall well below what could be considered a reasonable expectation. It appears that some reserve preparers may not be asking basic questions in the preparation of their studies. When your clients, who actually maintain the facilities, know more about the replacement requirements (replacement date and cost) than the professional reserve preparer, it's an indication that the reserve study is lacking.

Reserve study measurements are often estimated, and practitioners have reported measurements being misstated by more than 100 percent. Also, replacement costs are often understated because costs are taken from a construction cost-estimating manual without considering demolition and disposition costs, etc.

Also at issue is the preparation of the required AICPA Supplemental Reserve Disclosures. Many reserve preparers do not provide this information to their association clients, thus leaving it up to the association or its accountant to summarize the reserve study in the format required by the AICPA.

Any capable reserve preparer should be able to provide this information, and the CPA should encourage his or her clients to obtain this information from the reserve preparer.<sup>5</sup> CPAs generally should *not* attempt to summarize this information themselves. Practitioners should refer to paragraphs 7.54 through 7.56 of the AICPA's Audit and Accounting Guide *Common Interest Realty Associations* for a description of their responsibilities regarding future major repairs and replacements. Given the

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5. The Community Association Institute (CAI) provides qualified preparers with a reserve professionals designation (R.S.) upon confirmation of both educational background and minimum experience levels in the preparation of reserve studies.

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widely divergent practices of reserve preparers nationwide, auditors should be mindful of two significant areas: (1) the lack of adequate reporting on reserves, and (2) the sufficiency of the procedures underlying the reserve study itself when inquiring about accuracy and completeness. Auditors should be cautioned to simply ask their clients whether *they* believe they have an adequate reserve study. Many CIRA clients may respond that they do not believe their reserve study is adequate, because it does not include all components, has incorrect pricing or measurements, or has incorrect replacement dates that do not match their maintenance program. Auditors should be alert to the fact that this has a direct financial impact on the association, since relying on inadequate reserve studies can result in massive special assessments. Auditors are reminded that CIRA managers, who know the physical complex better than anyone, are the best source of information about the reliability of the reserve study. Auditors may also refer to paragraph 7.56 of the Audit and Accounting Guide *Common Interest Realty Associations* for additional guidance on limited procedures for the auditor to follow with respect to supplemental disclosures.

Historically, much emphasis has been placed on the hard costs of reserves, such as replacing a roof, while little attention is paid to soft costs such as upgrading technology (for example, switching to broadband). Other soft costs may include training staff and/or board members. Auditors should be aware of these costs in reserve studies as well.

Finally, since reserve fund projections make assumptions about interest rates that the reserve funds may earn, associations may need to reexamine those assumptions in light of today's low rates.

## **Accounting Issues and Developments**

### **Deferred Revenue on Special Assessments**

Currently, many buildings are enduring major renovations because of the age of the building. As a result of this, other large assessments, and receipt of settlements, deferred revenue on

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assessments, has become a topic of uncertainty concerning the proper way to record such transactions.

In addition to special assessments for renovations and replacements, deferred revenue can be recorded when CIRAs special assess for major operating expenditures, such as large annual insurance premiums (or large premium increases over budgeted amounts), and the policy periods extend beyond the balance-sheet date. Deferred revenues can also be applicable when CIRAs receive insurance proceeds or legal settlements that are earmarked for future expenditures.

Deferred revenue may include items such as special assessments designated for specific costs that have not yet been incurred. Such amounts should be recorded as revenues when the corresponding liabilities and expenses are reported. However, periodic assessments for funding future major repairs and replacements should be recorded in the periods in which they are assessed, regardless of whether they have been collected or expended.

There exists a great deal of confusion about deferred revenue. Some circumstances in which this confusion arises include the following:

- In the middle of a fiscal year, the CIRA levies a special assessment for insurance premiums in excess of the budgeted amount. To the extent that the policy period extends beyond the balance-sheet date, the CIRA should defer the recognition of revenues for that portion of the special assessment intended to supplement the succeeding fiscal period's expenses.
- The CIRA levies a special assessment for the specific costs of identified major projects. The revenues should be deferred, and recognized as the corresponding liabilities and expenses are reported. If the CIRA's actual project expenses exceed the revenues, the excess are generally recognized at the earliest point with the deferred revenue recorded for expenditures not yet incurred.

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- One method that could be utilized is if the association enters into contracts for major projects which are financed by third-party lenders to cover the principal and interest payments. The association levies a special assessment coinciding with the debt repayments. Since a special assessment was imposed, the entire charge to the owners should be recorded as a receivable with a credit to deferred revenue. The deferred revenue is systematically taken into income as the debt payments are made.
  - Assume most of the same facts as in the preceding scenario, but that, in lieu of a special assessment to repay the debt, the CIRA board of directors decides to include the charges to the members for the loan payments in the CIRA's annual operating budgets. In this situation, deferred revenue cannot be recognized, because the assessments are for the current year's debt obligations.
  - The CIRA receives insurance proceeds or developer settlement proceeds. Whenever the CIRA receives funds that are earmarked for specific purposes, it should report deferred revenue and recognize revenue as the related expenses are incurred.
  - The association receives regular assessments in advance. Sometimes, owners prepay their regular assessments. In those circumstances, CIRAs should report a liability, which is generally referred to as either "prepaid maintenance fees" or "assessments received in advance."

### Disclosure Issues

The footnotes to the financial statements should include disclosure of the CIRA's treatment of deferred revenue. Footnotes or an accompanying schedule can include a tabular analysis of the changes in deferred revenues during the reporting period. This analysis would be similar to the analysis of major repairs and replacement accounts pursuant to Exhibit A-7 of the AICPA's Audit and Accounting Guide *Common Interest Realty Associations*.

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## **Financing of Operating Fund Deficits and Special Projects**

Some CIRAs handle special projects by borrowing from a financial institution, rather than imposing a special assessment on the unit owners for the cost all at once. From a financial reporting standpoint, some boards report the loan activity in a separate “debt obligation fund.” Two principal benefits of this are (1) eliminating the portion of the operating fund deficit that is financed and (2) providing a separate accounting of the sources of borrowings as well as the sources for funding debt repayment.

## **Environmental Remediation Liabilities**

CIRAs are increasingly subject to environmental claims, especially claims concerning problems with mold. Despite the fact that the scientific evidence correlating mold and health problems is still weak, mold is a growing concern for CIRAs, as evidenced by an increasing number of lawsuits. While damage from mold is specifically excluded from standard homeowners’ policies, it is covered if it is the result of a covered risk, such as a burst pipe that causes water damage. The mold factor is contributing to a rise in insurance premiums and an increase in the number of exclusions as insurance companies try to reduce claims. The average cost to clean up mold last year was \$300,000 and that amount continues to escalate. The insurance industry spent \$15 billion on mold-related matters alone in 2002. According to the Insurance Information Institute, the average policy cost for homeowners rose 8 percent in 2002, and it expects premium costs to increase another 9 percent this year. The rate increases are needed, in part, to cover the cost of mold claims that are threatening to make home insurance coverage unaffordable for some and unavailable to others.

Is mold going to be the next asbestos? Time will tell. In 2002, the Conyers Bill-U.S. Toxic Mold Safety and Protection Act was introduced in the House by Representative John Conyers. However, no progress on the legislation is expected in the near term until the appropriate studies have been completed and the relationship between mold and health problems, if any, is scientifically confirmed.



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Besides mold issues, a CIRA may have the following environmental considerations:

- *Leaking underground storage tanks (LUST).* Heating oil for housing units and gasoline for vehicles may be stored underground at a CIRA. Federal, state, and local regulations require monitoring of those storage tanks for leaks. Also, if leaks occur, the cleanup of the surrounding soil is expensive and only partially covered in typical CIRA insurance policies.
- *Wetlands.* Federal law protecting wetlands may affect a CIRA's ability to make changes to its property when the CIRA is located on or near wetlands.
- *Mildew and other toxic chemicals.* CIRAs are seeing these "toxic torts" as construction, rehabilitation, and related property maintenance problems grow.
- *Waste disposal practices.* Depending on the types of substances being used and disposed of at a CIRA (for example, fertilizers and paints), regulations exist that are designed to prevent the release of hazardous substances into the environment. These regulations pertain to various matters, including the types of containers in which the wastes are stored and the land and structures surrounding them.

The questions that should arise involving a potential mold issue or any other environmental issue are:

1. Does your client have an environmental problem?
2. If your client has an environmental problem, does a contingency exist and does a potential loss need to be accrued?
3. What information needs to be disclosed?

AICPA Statement of Position (SOP) 96-1, *Environmental Remediation Liabilities*, provides accounting guidance for the recognition, measurement, display, and disclosure of environmental remediation liabilities. SOP 96-1 requires that environmental remediation liabilities be accrued when the criteria in Financial

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Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, are met. SOP 96-1 includes benchmarks to aid in the determination of when an entity is identified as a potentially responsible party (PRP) and when a feasibility study is completed. SOP 96-1 also requires that the accrual for environmental remediation liabilities include the incremental direct costs of the remediation effort and the costs of compensation and benefits for employees who are expected to devote a significant amount of time directly to the remediation effort.

Auditors should consider whether management has followed the guidance set forth in SOP 96-1, FASB Statement No. 5, FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, and FASB Emerging Issues Task Force (EITF) Issue No. 93-5, *Accounting for Environmental Liabilities*.

### **Update on Accounting Projects That May Be Relevant to CIRAs**

Accounting standard-setters are addressing the time-share issue, which could affect CIRAs. Although the final pronouncement may not be issued and effective for some time, you may want to acquaint yourself with how this issue is being addressed, and how it may change existing practice, and how it may affect your CIRA clients. Some clients will require assistance to understand or otherwise prepare for any new accounting guidance.

### **Accounting for Real Estate Time-Sharing Transactions**

In February 2003, the AICPA Accounting Standards Executive Committee issued an exposure draft of a Statement of Position (SOP) titled *Accounting for Real Estate Time-Sharing Transactions*, which provides guidance on a seller's accounting for real estate time-sharing transactions in financial statements prepared in conformity with generally accepted accounting principles (GAAP). The provisions of this proposed SOP would be effective for financial statements issued for fiscal years beginning after June 15, 2004. Earlier application would be encouraged. Readers should be alert for the issuance of a final pronouncement.

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The issues addressed in this proposed SOP are quite extensive. Readers should visit AICPA online at [www.aicpa.org/members/div/acctstd/edo/timeshare\\_2003\\_0204.asp](http://www.aicpa.org/members/div/acctstd/edo/timeshare_2003_0204.asp) for the complete exposure draft.

### **Accounting for Real Estate Time-Sharing Transactions, an amendment of FASB Statements Nos. 66 and 67**

In connection with the SOP project above, the Financial Accounting Standards Board issued a proposed Statement of Financial Accounting Standards titled *Accounting for Real Estate Time-Sharing Transactions, an amendment of FASB Statements No. 66 and 67*, which would amend FASB Statement No. 66, *Accounting for Sales of Real Estate*, and Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, to exclude from each Statement's scope the accounting for real estate time-sharing transactions. The accounting for those activities would be subject to the guidance in the proposed AICPA Statement of Position discussed above. The proposed Statement would be effective for financial statements for fiscal years beginning after June 15, 2004. Readers should be alert for the issuance of a final pronouncement.

## **Auditing and Attestation Pronouncements and Guidance Update**

Presented below is a list of auditing and attestation pronouncements and other guidance issued since the publication of last year's general *Audit Risk Alert —2002/03*. The AICPA *Audit Risk Alert —2003/04* contains a summary explanation of all these issuances. For information on auditing and attestation standards issued subsequent to this Alert, please refer to the AICPA Web site at [www.aicpa.org/members/div/auditstd/technic.htm](http://www.aicpa.org/members/div/auditstd/technic.htm). You may also look for announcements of newly issued standards in the *CPA Letter* and *Journal of Accountancy*.

To obtain copies of AICPA standards and guides, contact Member Satisfaction at (888) 777-7077 or go online at [www.cpa2biz.com](http://www.cpa2biz.com).

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SAS No. 97	<i>Amendment to Statement on Auditing Standards No. 50, Reports on the Application of Accounting Principles (AICPA, Professional Standards, vol. 1, AU sec. 625)</i>
SAS No. 98	<i>Omnibus Statement on Auditing Standards —2002 (AICPA, Professional Standards, vol. 1)</i>
SAS No. 99	<i>Consideration of Fraud in a Financial Statement Audit (AICPA, Professional Standards, vol. 1, AU sec. 316)</i>
SAS No. 100	<i>Interim Financial Information (AICPA, Professional Standards, vol. 1, AU sec. 722)</i>
SAS No. 101	<i>Auditing Fair Value Measurements and Disclosures (AICPA, Professional Standards, vol. 1, AU sec. 328)</i>
SOP 03-2	<i>Attest Engagements on Greenhouse Gas Emissions Information</i>
SSAE No. 12	<i>Amendment to Statement on Standards for Attestation Engagements No. 10, Attestation Standards: Revision and Recodification (AICPA, Professional Standards, vol. 1, AT secs. 101.17-.18)</i>
Interpretation No. 16 of SAS No. 58	“Effect on Auditor’s Report of Omission of Schedule of Investments by Investment Partnerships That Are Exempt From Securities and Exchange Commission Registration Under the Investment Company Act of 1940”
Amendment to Interpretation No. 2 of SAS No. 31	“The Effect of an Inability to Obtain Evidential Matter Relating to Income Tax Accruals”
Interpretation No. 5 of chapter 1, “Attest Engagements,” of SSAE No. 10: Attestation Standards: Revision and Recodification (AT section 101), as amended	<i>Interpretation No. 5. Attest Engagements on Financial Information Included in XBRL Instance Documents</i>
Interpretation 23 of SSARS No. 1	“Applicability of Statements on Standards for Accounting and Review Services When an Accountant Engaged to Perform a Business Valuation Derives Information From an Entity’s Tax Return”

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## Accounting Pronouncements and Guidance Update

Presented below is a list of accounting pronouncements and other guidance issued since the publication of last year's general *Audit Risk Alert –2002/03*. The AICPA *Audit Risk Alert –2003/04* contains a summary explanation of all these issuances. For information on accounting standards issued subsequent to this Alert, please refer to the AICPA Web site at [www.aicpa.org](http://www.aicpa.org) and the FASB Web site at [www.fasb.org](http://www.fasb.org). You may also look for announcements of newly issued standards in the *CPA Letter* and *Journal of Accountancy*.

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FASB Statement No. 145	<i>Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections</i>
FASB Statement No. 146	<i>Accounting for Costs Associated with Exit or Disposal Activities</i>
FASB Statement No. 147	<i>Acquisitions of Certain Financial Institutions</i>
FASB Statement No. 148	<i>Accounting for Stock-Based Compensation-Transition and Disclosure</i>
FASB Statement No. 149	<i>Amendment of Statement 133 on Derivative Instruments and Hedging Activities</i>
FASB Statement No. 150	<i>Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity</i>
FASB Interpretation No. 45	<i>Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others</i>
FASB Interpretation No. 46	<i>Consolidation of Variable Interest Entities</i>
FASB Technical Bulletin No. 01-1	<i>Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 Related to the Isolation of Transferred Financial Assets</i>
SOP 03-1	<i>Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts</i>
Questions and Answers	<i>FASB Statement No. 140</i>

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SSARS Interpretations	<i>Interpretations of AR Section 100:</i> <ul style="list-style-type: none"> <li>• 8. <i>Reports on Specified Elements, Accounts, or Items of a Financial Statement — Revised</i></li> <li>• 24. <i>Reference to the Country of Origin in a Review or Compilation Report</i></li> <li>• 25. <i>Omission of the Display of Comprehensive Income in a Compilation</i></li> </ul>
Interpretation 22 of SSARS No. 1	“Use of Selected Information—Substantially All Disclosures Required by Generally Accepted Accounting Principles Are Not Included”

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## On the Horizon

Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. Presented below is brief information about some ongoing projects that are especially relevant to the CIRA industry. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing generally accepted accounting principles (GAAP) or generally accepted auditing standards (GAAS).

The following table lists the various standard-setting bodies' Web sites, where information may be obtained on outstanding exposure drafts and where copies may be obtained for downloading.

<i>Standard-Setting Body</i>	<i>Web Site</i>
AICPA Auditing Standards Board (ASB)	<a href="http://www.aicpa.org/members/div/auditstd/drafts.htm">www.aicpa.org/members/div/auditstd/drafts.htm</a>
Public Company Accounting Oversight Board (PCAOB) (Note that for audits of public companies, the PCAOB sets auditing standards.)	<a href="http://www.pcaobus.org">www.pcaobus.org</a>
AICPA Accounting Standards Executive Committee (AcSEC)	<a href="http://www.aicpa.org/members/div/acctstd/edo/index.htm">http://www.aicpa.org/members/div/acctstd/edo/index.htm</a>

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Financial Accounting Standards Board (FASB)	<a href="http://www.rutgers.edu/Accounting/raw/fasb/draft/draftpg.html">www.rutgers.edu/Accounting/ raw/fasb/draft/draftpg.html</a>
Professional Ethics Executive Committee (PEEC)	<a href="http://www.aicpa.org/members/div/ethics/index.htm">www.aicpa.org/members/ div/ethics/index.htm</a>

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**Help Desk**—The AICPA’s standard-setting committees are now publishing exposure drafts of proposed professional standards exclusively on the AICPA Web site. The AICPA will notify interested parties by e-mail about new exposure drafts. To be put on the notification list for all AICPA exposure drafts, send your e-mail address to [memsat@aicpa.org](mailto:memsat@aicpa.org). Indicate “exposure draft e-mail list” in the subject header field to help process the submission more efficiently. Include your full name, mailing address and, if known, your membership and subscriber number in the message.

## **New Framework for the Audit Process <sup>6</sup>**

The AICPA Auditing Standards Board (ASB) is reviewing the auditor’s consideration of the risk assessment process in the auditing standards, including the necessary understanding of the client’s business and the relationships among inherent, control, fraud, and other risks. The ASB issued a series of exposure drafts in early 2003. Some participants in the process expect the final standards to have an effect on the conduct of audits that has not been seen since the “Expectation Gap” standards were issued in 1988.

Some of the more important changes to the standards that have been proposed are the following:

- A requirement for a more robust understanding of the entity’s business and environment that is more clearly linked to the assessment of the risk of material misstatement of the financial statements. (Among other things, this will improve the auditor’s assessment of inherent risk and eliminate the “default” to assess inherent risk at the maximum.)

.....  
6. Note that this discussion of auditing standards does not apply to audits of public companies

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- An increased emphasis on the importance of entity controls with clearer guidance on what constitutes a sufficient knowledge of controls to plan the audit.
  - A clarification of how the auditor may obtain evidence about the effectiveness of controls in obtaining an understanding of controls.
  - A clarification of how the auditor plans and performs auditing procedures differently for higher and lower assessed risks of material misstatement at the assertion level while retaining a “safety net” of procedures.

These changes collectively are intended to improve the guidance on how the auditor operationalizes the audit risk model.

You should keep abreast of the status of these projects and projected exposure drafts, inasmuch as they will substantially affect the audit process. More information can be obtained on the AICPA’s Web site at [www.aicpa.org](http://www.aicpa.org).

## **Resource Central**

Presented below are various resources that practitioners engaged in the CIRA industry may find beneficial.

### **Publications**

The following publications deliver valuable guidance and practical assistance as potent tools to be used on your engagements (product numbers appear in parentheses).

- *Checklists and Illustrative Financial Statements for Common Interest Realty Associations* (product no. 008789kk). This publication is designed to help those preparing reports and financial statements of CIRAs by providing a checklist of applicable generally accepted accounting principle (GAAP) disclosures.



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- Fraud Detection in a GAAS Audit: SAS No. 99 Implementation Guide (product no. 006613kk)
  - *Analytical Procedures* Audit Guide (012551kk)
  - *Auditing Estimates and Other Soft Accounting Information* Practice Aid (010010kk)
  - *Accounting Trends and Techniques* —2003 (009895kk)
  - *Preparing and Reporting on Cash- and Tax-Basis Financial Statements* Practice Aid (006701kk)
  - *Understanding and Implementing* SSARS No. 8 (006612kk)
  - *Professional Standards* 2003 (product no. 005103kk)
  - *Technical Practice Aids* (product no. 005143kk). This product includes questions received by the AICPA Technical Hotline on various subjects and the responses to those questions. Sections 6140 and 6960 include questions and answers specifically pertaining to CIRAs.
  - *Audit and Accounting Manual* (product no. 005133kk). This manual is a valuable nonauthoritative practice tool designed to provide assistance for audit, review, and compilation engagements. It contains numerous practice aids, samples, and illustrations, including audit programs, auditors' reports, checklists and engagement letters, management representation letters, and confirmation letters.

## CD-ROMS

The AICPA is currently offering a CD-ROM product titled **RESOURCE: AICPA's Accounting and Auditing Literature**. This CD-ROM enables subscription access to the following AICPA Professional Literature products in a Windows format: *Professional Standards*, *Technical Practice Aids*, and *Audit and Accounting Guides* (available for purchase as a set that includes all Guides and the related Audit Risk Alerts, or as individual publications). This dynamic product allows you to purchase the specific titles you need and includes hypertext links to references within and between all products.

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## **AICPA Online and CPA2BIZ**

AICPA Online offers CPAs the unique opportunity to stay abreast of matters relevant to the CPA profession. AICPA Online informs you of developments in the accounting and auditing world as well as developments in congressional and political affairs affecting CPAs. In addition, CPA2BIZ.com offers all the latest AICPA products, including Audit Risk Alerts, Audit and Accounting Guides, *Professional Standards*, *Technical Practice Aids*, and CPE courses.

## **Member Satisfaction Center**

To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Member Satisfaction Center at (888) 777-7077.

## **Hotlines**

### **Accounting and Auditing Technical Hotline**

The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

### **Ethics Hotline**

Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. Call (888) 777-7077.

## **Continuing Professional Education Courses**

The AICPA offers many continuing professional education (CPE) courses that may be of value to CPAs working in the CIRA industry. Among the available titles are the following:

- *AICPA's Annual Accounting and Auditing Workshop.* Whether you are in industry or public practice, this course keeps you current and informed, and shows you how to apply the most recent standards.

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- *Independence* (product no. 739150). This interactive CD-ROM course will review the AICPA authoritative literature covering independence standards, including the SEC Practice Section (SECPS) independence requirements, SEC regulations on independence, and International Standards Board (ISB) standards.

For more information about AICPA CPE courses, call the AICPA (Member Satisfaction) at (888) 777-7077 or visit the AICPA Web site at [www.aicpa.org](http://www.aicpa.org).

### **Online CPE**

AICPA InfoBytes, offered exclusively through CPA2Biz.com, is AICPA's flagship online learning product. Selected as one of *Accounting Today's* top 100 products for 2003, AICPA InfoBytes now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay \$149 (\$369 nonmembers) for a new subscription and \$119 (\$319 nonmembers) for the annual renewal. Divided into one- and two-credit courses that are available 24/7, AICPA InfoBytes offers hundreds of hours of learning in a wide variety of topics. To register or learn more, visit [www.cpa2biz.com/infobytes](http://www.cpa2biz.com/infobytes).

### **Other Guidance**

Auditors should also be aware of the economic, regulatory, and professional developments that may affect the audits they perform, as described in the AICPA general *Audit Risk Alert—2003/04* (product no. 022334kk) and AICPA *Compilation and Review Alert—2003/04* (product no.022303kk). These Alerts may be obtained by calling the AICPA Order Department (Member Satisfaction) at (888) 777-7077, by subscribing to AICPA reSOURCE, or by faxing a request to (800) 362-5066. Obtaining product information and placing online orders can be done at [www.CPA2biz.com](http://www.CPA2biz.com).

Copies of FASB publications referred to in this document may be obtained directly from the FASB by calling the FASB Order Department at (800) 748-0659.

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The Audit Risk Alert *Common Interest Realty Associations Industry Developments* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Alert, please feel free to share those with us. Any other comments that you have about the Alert would also be appreciated. You may e-mail these comments to [lwest@aicpa.org](mailto:lwest@aicpa.org), or write to:

Lori A. West, CPA  
AICPA  
Harborside Financial Center  
201 Plaza Three  
Jersey City, NJ 07311-3881

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**APPENDIX A**

***Illustrative Management Representation  
Letter— Review***

*[To be prepared on the CIRA's or managing agent's letterhead]*

*[Date of Accountant's Report]*

*[To the Accountant]*

We are providing this letter in connection with your review of the balance sheet and the related statements of revenues, expenses, and changes in fund balances, and cash flows of XYZ Condominium Association as of December 31, 20XX, and for the year then ended, for the purpose of expressing limited assurance that there are no material modifications that should be made to the statements in order for them to be in conformity with generally accepted accounting principles. We confirm that we are responsible for the fair representation in the financial statements of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.

Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would be changed or influenced by the omission or misstatement.<sup>7</sup>

We confirm, to the best of our knowledge and belief, (as of [a date no earlier than the date of review report, see AR section 100.29]), the following representations made to you during your review.

.....  
7. The qualitative discussion of materiality used in this letter is adapted from Financial Accounting Standards Board, Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information*.

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1. The financial statements referred to above are fairly presented in conformity with generally accepted accounting principles.
  2. We have made available to you all:
    - a. Financial records, loan documents, reserve studies, and related data.
    - b. Minutes of the meetings of stockholders, directors, trustees, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.
  3. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.
  4. We have no plans or intentions that may materially affect the carrying amounts or classification of assets and liabilities.
  5. There are no material losses (such as from purchase or sales commitments) that have not been properly accrued or disclosed in the financial statements.
  6. There are no:
    - a. Violations or possible violations of laws or regulations, whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.
    - b. Unasserted claims or assessments that our lawyer has advised us are probable of assertion that must be disclosed in accordance with Financial Accounting Standards Board (FASB), Statement of Financial Accounting Standards No. 5 [AC section C59], *Accounting for Contingencies*.<sup>8</sup>
    - c. Other material liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB Statement No. 5.

.....  
8. If management has not consulted a lawyer regarding litigation, claims, and assessments, the representation might be worded as follows: "We are not aware of any pending or threatened litigation, claims, or assessments or unasserted claims or assessments that are required to be accrued or disclosed in the financial statements in accordance with Financial Accounting Standards Board Statement No. 5 [AC section C59], *Accounting for Contingencies*, and we have not consulted a lawyer concerning litigation, claims, or assessments."

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7. The Association has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged as collateral.
  8. We have complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.
  9. The following have been properly recorded or disclosed in the financial statements:
    - a. Related party transactions, including sales, purchases, loans, transfers, leasing arrangements, and guarantees, and amounts receivable from or payable to related parties.
    - b. Guarantees, whether written or oral, under which the Association is contingently liable.
    - c. Significant estimates and material concentrations known to management that are required to be disclosed in accordance with the AICPA's Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties*. [Significant estimates are estimates at the balance-sheet date that could change materially within the next year. Concentrations refer to volumes of business, revenues, available sources of supply, or markets for which events could occur that would significantly disrupt normal finances within the next year.]
  10. To the best of our knowledge and belief, no events have occurred subsequent to the balance-sheet date and through the date of this letter that would require adjustment to or disclosure in the aforementioned financial statements.
  11. We have responded fully and truthfully to all inquiries made to us by you during your review.
  12. The board of directors is collecting funds for major repairs and replacements in conformity with the Association's policy to fund for those needs based on a study conducted in November 20X2. The board of directors believes that the funds will adequately provide for future major repairs and replacements.

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13. The Association's allocation of expenses for income tax purposes is considered to be reasonable and consistent, and is adequately documented.

XYZ CONDOMINIUM ASSOCIATION



## ***Illustrative Management Representation Letter—Audit***

AICPA Statement on Accounting Standards (SAS) No. 85, *Management Representations*, (AICPA, *Professional Standards*, vol. 1, AU sec. 333), as amended by SAS No. 89, *Audit Adjustments* (AICPA, *Professional Standards*, vol. 1, AU secs. 310, 333, and 380), and SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), requires an auditor to obtain written representations from management for all financial statements and periods covered by the audit's report. The specific written representations obtained by the auditor will depend on the circumstances of the engagement and the nature and basis of presentation of the financial statements. For example, due to the CIRA operating environment, the lack of segregation of duties is almost a given and constant point on every self-managed association. Usually, lack of segregation is less of a problem when management companies are involved.

### **Illustrative Representation Letter—Audit**

*[To be prepared on the CIRA's or managing agent's letterhead]*

*[Date of Auditor's Report]*

*[To the Independent Auditor]*

We are providing this letter in connection with your audit of the balance sheets and the related statements of revenues, expenses, and changes in fund balances, and cash flows of XYZ Condominium Association as of December 31, 20XX and 20XX for the years then ended, for the purpose of expressing an opinion as to whether the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of XYZ Condominium Association in conformity with generally accepted accounting principles. We confirm that we are responsible for the fair presentation in the financial statements of financial position, results of opera-

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tions, and cash flows in conformity with accounting principles generally accepted in the United States of America.

Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would be changed or influenced by the omission or misstatement.

We confirm, to the best of our knowledge and belief, [as of *(date of auditor's report)*,] the following representations made to you during the audit:

1. The financial statements referred to above are fairly presented in conformity with accounting principles generally accepted in the United States of America.
2. We are responsible for the fair presentation of the information about future major repairs and replacements in the supplementary information accompanying the financial statements.
3. We have made available to you all:
  - a. Financial records and related data.
  - b. Minutes of the meetings of directors and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.
4. There have been no communications from regulatory agencies concerning noncompliance with or deficiencies in financial reporting practices.
5. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.
6. We believe that the effects of the uncorrected financial statement misstatements summarized in the accompanying schedule are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.<sup>9</sup>

.....  
9. If management believes that certain of the identified items are not misstatements, management's belief may be acknowledged by adding to the representation, for example, "We do not agree that items XX and XX constitute misstatements because [description of reasons]."

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7. We acknowledge our responsibility for the design and implementation of programs and controls to prevent and detect fraud.
  8. We have no knowledge of any fraud or suspected fraud affecting the entity involving:
    - a. Management,
    - b. Employees who have significant roles in internal control, or
    - c. Others that could have a material effect on the financial statements.
  9. We have no knowledge of any allegations of fraud or suspected fraud affecting the entity received in communications from employees, former employees, or others.
  10. We have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.
  11. The following have been properly recorded or disclosed in the financial statements:
    - a. Related party transactions, including sales, purchases, loans, transfers, leasing arrangements, and guarantees, and amounts receivable from or payable to related parties.
    - b. Guarantees, whether written or oral, under which the Association is contingently liable.
    - c. Significant estimates and material concentrations known to management that are required to be disclosed in accordance with the AICPA's Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties*. (Significant estimates are estimates at the balance-sheet date that could change materially within the next year. Concentrations refer to volumes of business, revenues, available sources of supply, or markets or geographic areas for which events could occur that would significantly disrupt normal finances within the next year.)
  12. There are no:
    - a. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in

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the financial statements or as a basis for recording a loss contingency.

- b. Unasserted claims or assessments that our lawyer has advised us are probable of assertion and must be disclosed in accordance with FASB Statement No. 5, *Accounting for Contingencies*.<sup>10</sup>
  - c. Other liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB Statement No. 5.
- 13. The Association has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets, nor has any asset been pledged as collateral.
  - 14. We have complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.
  - 15. The board of directors is collecting funds for major repairs and replacements in conformity with the Association's policy to fund for those needs based on a study conducted in November 20XX. The board of directors believes that the funds will adequately provide for future major repairs and replacements.
  - 16. The Association's allocation of expenses for income tax purposes is considered to be reasonable and consistent, and is adequately documented.
  - 17. The board of directors has allocated the excess of the Association's revenues over its expenses during the current year to the fund for future major repairs and replacements.
  - 18. To the best of our knowledge and belief, no events have occurred subsequent to the balance-sheet date and

.....  
10. In the circumstance discussed in footnote 7 of Statement on Auditing Standards (SAS) No. 85, *Management Representations*, this representation might be worded as follows, "We are not aware of any pending or threatened litigation, claims, or assessments or unasserted claims or assessments that are required to be accrued or disclosed in the financial statements in accordance with FASB Statement No. 5, *Accounting for Contingencies*, and we have not consulted a lawyer concerning litigation, claims, or assessments."

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through the date of this letter that would require adjustment to or disclosure in the aforementioned financial statements.

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*Signature and Title*

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*Signature and Title*

## ***Commonly Asked Questions and Answers***

The following questions and answers have been developed by individuals in the CIRA industry. They include frequently asked questions encountered by those individuals on accounting, auditing, and regulatory matters.

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***Q-The Association budgeted \$50,000 of its assessments to be allocated to the replacement fund. It actually funded only \$10,000 and has no intention of funding more. In this case, I booked \$10,000 as replacement fund assessments. Am I right?***

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***A-No.*** The AICPA Audit and Accounting Guide *Common Interest Realty Associations* (CIRA Guide) requires the budgeted assessment to be booked to income. Any amounts not funded are either set up as a “Due Between Funds” if the monies are going to be repaid, or a permanent transfer between funds is booked on the statement of changes in fund balances. In this case, the income statement would show income of \$50,000 and the fund balance would be reduced by \$40,000 on the fund balance statement.

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***Q-Is supplementary information on major repairs and replacements required for compilations and reviews?***

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***A-Yes.*** And if the information is missing, a paragraph must be added to the standard report.

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***Q-I just completed the 2002 audit for an association. The association had a reserve study done in 2001 for the 2002 year, and another study at the end of 2002 for the 2003 year. Which study do I include in the supplementary information?***

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***A-There is no guidance in this matter. It would appear that either study would be appropriate. There is some justification that the 2002 would be appropriate as this is the 2002 audit; yet, there is also justification to include the most recent study with the most***

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recent data. A few accountants include both. You may consider including the most recent study even if it is not in effect yet (disclose that fact in the footnotes), so the reader will have the most up-to-date information.

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***Q-Since condos and HOAs have lien rights and the ability to foreclose on a unit for unpaid assessments, is an allowance for bad debts necessary? If so, how is this computed?***

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A-Management still needs to determine whether a bad debt allowance is necessary, in that there may be no equity in a unit or a homeowner may go bankrupt. The allowance should be computed based upon the available information as to the collectibility of the amounts due. This requires much judgment, as such issues as solvency of the unit owner, equity in the unit, and the cost versus benefit rules must be considered. The opinions of the manager, the association's attorney (or collection agent), and the board are all useful input.

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***Q-Do I have to capitalize an asset to which the association has title and can sell in accordance with the CIRA Guide if the asset is included in the replacement fund and is paid out of that fund? The association will be funding for replacement of that asset. Do I still depreciate it?***

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A-Yes. If the asset qualifies to be capitalized, then the asset is booked on the financial statements in the operating fund. This will require a transfer between funds (on the statement on fund balance) from the replacement fund to the operating fund. The asset will be depreciated using GAAP and the replacement fund will continue funding for the replacement of the asset.

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***Q-Must I gain an understanding of a CIRA's internal control when performing a review engagement?***

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A-No. SSARS does not require the accountant to obtain an understanding of the client's internal control when conducting a compilation or review engagement.

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***Q-Do I have the responsibility to plan a compilation engagement for a CIRA to consider the risk of material misstatement that results from fraud?***

**A-No.** SSARS does not require the accountant to plan or perform a compilation or review engagement to obtain reasonable assurance that the financial statements are free of material misstatement, whether caused by error or fraud.

***Q-When are analytical procedures required when performing a SSARS engagement?***

**A-Analytical procedures** are required only in review engagements-not in compilation engagements.

***Q-Can the requirements found in SSARS for analytical procedures be modified?***

**A-Yes,** SSARS No. 1 states that knowledge acquired in the performance of other services may result in the modification of analytical procedures.

***Q-Should a summary of uncorrected misstatements be included with the management representation letter in a SSARS review engagement?***

**A-No.** The requirement in SAS No. 89 to include a list of uncorrected misstatements in the management representation letter does not apply to SSARS review engagements.

***Q-A CPA in public practice, who also serves as an officer or director of a CIRA:***

- a. May issue financial statements of the entity and comply with SSARS No. 1.
- b. May issue financial statements of the entity and use a transmittal letter that clearly indicates his or her relationship to the entity.
- c. Must comply with SSARS No. 1.
- d. Either a or b.

**A-d.- A CPA in the practice of public accounting who also serves as a stockholder, partner, director, officer, or employee of the**



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entity, may either (1) comply with the requirements of SSARS No. 1, or (2) communicate, preferably in writing, his or her relationship to the entity (for example, stockholder, partner, director, officer, or employee).

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***Q-Should written representations be obtained from current management for all periods covered by a review report?***

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A-Yes according to SSARS No. 9, Omnibus-2002.

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## APPENDIX D

### *Helpful Web Sites*

Web sites that may provide useful information to CPAs are listed in the following tables.

#### **Association-Related Information**

<i>Organization</i>	<i>General Contact Information</i>	<i>Internet Address</i>
Community Associations Institute	1630 Duke Street Alexandria, VA 22314 (703) 548-8600	<a href="http://www.caionline.org">www.caionline.org</a>
National Association of Housing Cooperatives	1401 New York Avenue #1100 Washington, DC 20005 (202) 383-5475	<a href="http://www.coophousing.org">www.coophousing.org</a>
American Resort Development Association	1220 L Street, Ste 500 Washington, DC 20005 (202) 371-6700	<a href="http://www.arda.org">www.arda.org</a>

#### **General Web Sites of Interest**

<i>Name of Site</i>	<i>Content</i>	<i>Internet Address</i>
American Institute of CPAs	Summaries of recent auditing and other professional standards as well as other AICPA activities	<a href="http://www.aicpa.org">www.aicpa.org</a>
Financial accounting Standards Board	Summaries of recent accounting pronouncements and other FASB activities	<a href="http://www.fasb.org">www.fasb.org</a>
The Electronic Accountant	World Wide Web magazine that features up-to-the-minute news for accountants	<a href="http://www.electronicaccountant.com">www.electronicaccountant.com</a>

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<i>Name of Site</i>	<i>Content</i>	<i>Internet Address</i>
CPAnet	Links to other Web sites of interest to CPAs	<a href="http://www.cpalinks.com/">www.cpalinks.com/</a>
Guide to WWW for Research and Auditing	Basic instructions on how to use the Web as an auditing research tool	<a href="http://www.tetranet.net/users/gaostl/guide.htm">www.tetranet.net/users/gaostl/guide.htm</a>
Accountant's Home Page	Resources for accountants and financial and business professionals	<a href="http://www.computercpa.com/">www.computercpa.com/</a>
Double Entries	A weekly newsletter on accounting and auditing around the world	<a href="http://www.csu.edu.au/lists">www.csu.edu.au/lists.</a>
U.S. Tax Code Online	A complete text of the U.S. Tax Code	<a href="http://www.fourmilab.ch/ustax/ustax.html">www.fourmilab.ch/ustax/ustax.html</a>
Federal Reserve Bank of New York	Key interest rates	<a href="http://www.ny.frb.org/pihome/statistics/dlyrates">www.ny.frb.org/pihome/statistics/dlyrates</a>
Cybersolve	Online financial calculators such as ratio and breakeven analysis	<a href="http://www.cybersolve.com/tools1.html">www.cybersolve.com/tools1.html</a>
FedWorld. Gov	U.S. Department of Commerce -sponsored site providing access to government publications	<a href="http://www.fedworld.com">www.fedworld.com</a>
Hoovers Online	Online information on various companies and industries	<a href="http://www.hoovers.com">www.hoovers.com</a>
Vision Project	Information on the profession's vision project	<a href="http://www.cpavision.org/horizon">www.cpavision.org/horizon</a>
Internet Bulletin for CPAs	CPA tool for Internet sites, discussion groups, and other resources for CPAs	<a href="http://www.kentis.com/ib.html">www.kentis.com/ib.html</a>

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<i>Name of Site</i>	<i>Content</i>	<i>Internet Address</i>
Federal Communication Commission	FCC-sponsored site providing access to rulings and other FCC information	<a href="http://www.fcc.gov/">www.fcc.gov/</a>
FannieMae	FannieMae-sponsored site providing access to products and other FannieMae information	<a href="http://www.fanniemae.com">www.fanniemae.com</a>
FreddieMac	FreddieMac-sponsored site providing access to products, forms, business tools, and other FreddieMac information	<a href="http://www.freddiemac.com">www.freddiemac.com</a>
Department of Veterans Affairs	VA-sponsored site providing access to online applications, special programs, and other VA information	<a href="http://www.va.gov">www.va.gov</a>
U.S. Dept. of Housing and Urban Development	HUD-sponsored site providing access to notices and other HUD information	<a href="http://www.hud.gov/">www.hud.gov/</a>

